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SUPREME COURT, U.S.
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MICHAEL RODAK, JR.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-684

STEPHENS, INC.,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Eighth Circuit

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. .....

STEPHENS, INC.,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Eighth Circuit

Stephens, Inc., petitioner herein, respectfully requests that a Writ of Certiorari be issued to the United States Court of Appeals for the Eighth Circuit to review that Court's judgment entered in this action on July 10, 1972.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit appears in Appendix A hereof. That opinion is not yet officially reported. Petitioner, as Appellee and Cross-Appellant below, filed a timely Petition

for Rehearing. The Order of the Court of Appeals on Petition for Rehearing, denying petitioner's prayer, is reprinted in Appendix B hereof. The Memorandum Opinion of the United States District Court for the Eastern District of Arkansas is reported as **Stephens, Inc. v. United States**, 321 F. Supp. 1159 (E.D. Ark. 1970). The Memorandum Opinion of the United States District Court for the Eastern District of Arkansas, together with the Order of that Court entering judgment pursuant to that Opinion, appears in Appendix C hereof.

JURISDICTION

Petitioner filed timely claims for refund of Federal income taxes as required by 26 U.S.C. § 6402. Following denial of these claims, petitioner invoked the jurisdiction of the United States District Court under 28 U.S.C. § 1340, after having complied with the provision of 26 U.S.C. § 7422(a). The Memorandum Opinion and Order of the United States District Court were entered October 15, 1970. The Opinion of the United States Court of Appeals was entered July 10, 1972. On July 21, 1972, petitioner was granted ten days' leave within which to request Rehearing. Petitioner then timely sought Rehearing *en banc*, or by the Panel, which was denied August 22, 1972. This petition has been filed within ninety (90) days after August 22, 1972, as required by Rule 22(1). **Department of Banking v. Pink**, 317 U.S. 264 (1942); **United States v. Healey**, 376 U.S. 75 (1964). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Can an appellate court characterize a question of purpose or motive as a "mixed question of law and fact" and thereby deprive a litigant of the "buckler and

shield'"[1] of Rule 52(a) of the Federal Rules of Civil Procedure conferred upon him in the trial court?

2. Is momentary or fleeting control sufficient to satisfy the definition of "control" in 26 U.S.C. § 368(c)?

3. Where the shareholders of the liquidated corporation do not meet the control requirement of 26 U.S.C. § 368(c), can the transaction be characterized as a Type D reorganization within the meaning of 26 U.S.C. § 368(a)(1)(D)?

STATEMENT OF THE CASE

The case was tried before the United States District Court for the Eastern District of Arkansas without a jury. Trial resulted in a split decision on October 15, 1970, judgment being entered for the petitioner on certain issues and for the respondent on others. Respondent appealed those issues decided adversely to him to the United States Court of Appeals for the Eighth Circuit. Petitioner cross-appealed. On July 10, 1972, a three judge panel of the United States Court of Appeals for the Eighth Circuit reversed the portion of the District Court's decision which was decided favorably to the petitioner and affirmed that portion decided favorably to the respondent, dismissing the petitioner's cross-appeal.

Petitioner sought rehearing before the United States Court of Appeals for the Eighth Circuit *en banc*, or in the alternative, before the Panel, through a timely filed Petition. Rehearing was denied August 22, 1972.

Petitioner now seeks review before this Court of the entire decision of the United States Court of Appeals for the Eighth Circuit.

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[1] **Horton v. United States Steel Corp.**, 286 F.2d 710, 713 (5 Cir. 1961).

1. **Facts relating to the issues presented in Question 1**

Petitioner, a member of the Mid-West Stock Exchange and an associate member of the American Stock Exchange, acquired and disposed of a controlling interest in five Arkansas corporations under similar factual patterns. These five corporations were Stephens Finance Co.,[2] Public Utilities of Crossett, Arkansas,[3] Tuf-Nut Manufacturing Co.,[4] Hollis & Co.,[5] and V. E. Schevenell, Inc.[6] A synopsis of the dates of acquisition and disposition, and the percentage of ownership acquired and disposed of by petitioner is set out in **Stephens, Inc. v. United States**, 321 F.Supp. 1159, 1162 (E.D.Ark. 1970). See also Appendix C, infra, at page 33. These stocks were neither registered nor actively traded.

Petitioner placed each stock in its inventory account at cost. Dividends were declared and paid to Petitioner. Petitioner treated these amounts received as adjustments to the cost of each individual stock contained in the inventory account, reducing cost in a particular stock accordingly. The dividends were excluded from gross income in accordance with the rules prescribed in 26 U.S.C. § 243. Gain or loss realized upon a subsequent sale was treated as ordinary gain or loss.

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[2] Also known as El Dorado Waterworks Company, but referred to hereafter as "Stephens Finance".

[3] Hereafter referred to as "PUC".

[4] Also known as Little Rock Tent & Awning Co., but referred to hereafter as "Tuf-Nut".

[5] See Appendix A, page 7, Footnote 5. The Eighth Circuit found that no claim for refund was filed on behalf of Hollis & Co. Petitioner does not seek review of this determination.

[6] Hereafter referred to as "Schevenell".

On audit, the Commissioner objected, among other things, to characterization of the stock in these corporations as inventory items, and denied the adjustments writing the stocks down to their lower of cost or market. Petitioner paid the deficiencies assessed and filed timely claims for refund that were denied. Subsequent to denial, Petitioner commenced this action in the United States District Court for the Eastern District of Arkansas.

At the conclusion of the trial, the District Court, sitting without a jury, found that four of the five stocks, P.U.C., Tuf-Nut, Hollis & Co.,[7] and Schevenell, were acquired for the purpose of resale and not for speculative or investment purposes; but petitioner had failed to sustain the burden of proof on this issue with respect to Stephens Finance Co.

Respondent appealed this portion of the District Court's opinion, and petitioner cross-appealed with respect to Stephens Finance Co. The Court of Appeals concurred in respondent's position, and concluded that (1) the dealer's profit must accrue **solely** from the resale of the security itself and cannot occur as the result of both dividend and resale profit, and (2) that, PUC in particular, was not acquired for the immediate purpose of creating a stock of securities that would allow petitioner to take care of future buying orders in excess of selling orders.

2. Facts related to the issue presented in Questions 2 and 3

On November 5, 1963, the shareholders of PUC adopted a plan of complete liquidation when the ownership thereof was as follows:

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[7] See Note 5, supra.

Name	Shares
Raney Investment Co., Inc.	800
Raney Securities Co., Inc.	2,697.5
Stephens, Inc.	2,797.5
Vernon Giss	250
G. W. Dickey	250
William M. Dickey	100
Ray Thornton	100

The Arkansas Public Service Commission approved a plan of reorganization November 26, 1963. Pursuant to this plan, the assets of PUC were transferred to a trustee and thence to Crossett Water Company[8] and to Public Utilities Corporation of Crossett[9] in return for stock and assumption of liabilities on December 2, 1963.

Stock of CWC and New Utilities was then transferred prorata to the former shareholders of PUC, including petitioner, Raney Investment Co., Inc., and Raney Securities Co., Inc. The stock of CWC was transferred to New Utilities December 24, 1963.

Two days later, December 26, 1963, petitioner sold all of its shares to J. T. and W. R. Stephens. Thereafter, the ownership in New Utilities was as follows:

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[8] Hereafter referred to as "CWC".

[9] Hereafter referred to as "New Utilities".

Name	Shares
Vernon J. Giss	501
George W. Dickey	501
William M. Dickey	200
Raymond H. Thorton, Jr.	200
Harry W. Parkin	523
Dallas P. Raney	1,078
Jack T. Lynn	525
William J. Smith	280
Herschel H. Friday	280
Allan G. Bragfell, Jr.	140
Frank R. Thurman	676
Robert W. Raney	762
Alton B. Raney	394
Mary O. Raney	482
Thomas D. Raney	394
Robert C. Thurman	48
Russell Thurman	48
Clay H. Raney	534
John H. Allen	180
John F. Gorman	180
Winston Faulkner	128
Sam Pallone and Sharon Pallone	348
W. R. Stephens	2,799
J. T. Stephens	2,799

The District Court concluded that the transaction was a non-taxable reorganization under 26 U.S.C. § 368(a)(1)(D). Petitioner cross-appealed this issue, and the Eighth Circuit affirmed for respondent.

REASONS FOR GRANTING THE WRIT

1. The Decision of the Court of Appeals Conflicts With the Decision of This Court in DUBERSTEIN.

Unless reviewed by this Court, the decision of the Court of Appeals threatens to rekindle a flame long since thought to have been extinguished.

This Court has established the principle that where a dispute is tried to the Court, sitting without a jury, the findings of the trier of fact must stand unless shown to be "clearly erroneous" within the meaning of Rule 52(a) of the Federal Rules of Civil Procedure. **Commissioner v. Duberstein**, 363 U.S. 278, 291 (1960). In the ensuing years, this principal has been rigidly adhered to in the lower courts.[10]

This issue involved the construction of 26 C.F.R., § 1.471-5, which provides in part as follows:

> ". . . For the purposes of this section, a dealer in securities is a merchant of securities, . . ., with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom . . ."

Petitioner's purpose or motive for the acquisition of these securities was the sole issue. Purpose and motive are pregnant with the suggestion of subjectivity. The Dis-

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[10] The Third Circuit's position is that, "The principle which formerly had much vitality that a reviewing court is just as competent as the trial tribunal to determine what inferences should be drawn from the findings of fact no longer applies". **Imbesi v. Commissioner**, 361 F.2d 640, 643 (3 Cir. 1966). See also **Joshel v. Commissioner**, 296 F.2d 645 (10 Cir. 1961); and **Savko Brothers Co. v. Commissioner**, 338 F.2d 956 (6 Cir. 1964).

trict Court considered all factors presented in evidence; and, based upon the stipulated facts and the testimony heard, it concluded that petitioner acquired certain stocks for resale and not for investment or speculative purposes. **Stephens, Inc. v. United States**, 321 F.Supp. 1159, 1165 (E.D.Ark. 1970). See also Appendix C, *infra* at page 39.

The Court of Appeals sharply disagreed with the lower court's finding on this point. The reviewing court did not find, nor did it intimate, that the lower court's factual determination was "clearly erroneous." Instead, the Court of Appeals applied a pre-**Duberstein** principle, and reviewed the District Court's factual determination.

Multiple decisions have established the general proposition that where a holder, including the securities dealer, acquires a security for the **primary** purpose of benefiting from the income yield, the holder is not a "dealer" with respect to that security and is not entitled to inventory treatment. See **United States v. Chinook Investment Co.**, 136 F.2d 984 (9th Cir. 1943); **Commissioner v. Charavay**, 79 F.2d 406 (3 Cir. 1935); **Securities Allied Corp. v. Commissioner**, 95 F.2d 384 (2 Cir. 1938) **cert. denied**, 305 U.S. 617 (1938). Where the evidence indicates the presence of mixed motives, the analysis of the evidence to ascertain which motive is "primary" among them has been reserved to the initial trier of fact by **Duberstein**. See also **Malat v. Riddle**, 383 U.S. 569 (1966).

The Court of Appeals reviewed the entire record and redetermined petitioner's primary purpose. Appendix A, *infra* at pages 7-10. Based upon this independent determination of petitioner's primary purpose, the District Court was reversed.

Encroachment into the area reserved for the trial court was camouflaged through characterization of the question as one of mixed law and fact. Two prior decisions of this Court were invoked as authority for that characterization,

Schafer v. Helvering, 299 U.S. 171 (1936); and **Fried v. Helvering**, 299 U.S. 175 (1936). Careful analysis of these decisions reveals that both were affirmed upon an application of the regulation to the facts as they were determined or stipulated before the initial trier of fact.[11]

Petitioner requests that the Court look to its own crowded docket, and to the dockets of the various lower courts throughout the Federal system, to determine the importance of this issue.

Litigation must serve as a terminating device in disputes between parties. Litigation cannot, and will not, serve this function so long as one party feels that it is permissible to loose the factual battle before the initial trier of fact; but yet, ultimately win the legal war through relitigation of one or more of the disputed issues on appeal.

This conflict justifies the grant of certiorari to review the decision of the Eighth Circuit.

2. **The Decision Below Conflicts With Decisions of Other Courts of Appeals as to the Proper Interpretation of 26 U.S.C. §§ 368(a)(1)(D) and 368(c).**

The applicable provisions of 26 U.S.C. § 368 are as follows:

"(a) Reorganization.

(1) In General—For purposes of parts I and II and this part, the term "reorganization" means—

. . . .

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[11] In **Fried**, the Second Circuit had reversed the Board of Tax Appeals because of an erroneous determination that a "specialist" could not be a dealer. **Fried v. Commissioner**, 83 F. 2d 193 (2 Cir. 1936).

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

. . . .

(c) Control—For purposes of part I . . . and part II, and this part, the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

During a period extending from November 5, 1963, to December 26, 1963, the ownership of the proprietary interest of these two corporations underwent a dramatic transformation.

The Eighth Circuit chose to rely upon the grandfather of the so-called step-transaction theory, **American Bantam Car Co. v. Commissioner**, 11 T.C. 397 (1948), **aff'd per curiam** 177 F.2d 513 (3d Cir. 1949), **cert. denied** 339 U.S. 920 (1950). The Tax Court went so far as to say that "momentary control" would be sufficient to satisfy the eighty percent (80%) requirement.

A contrary position has been taken by the Second Circuit. Where the transferor of property receives stock, and then conveys to third parties (who cannot be classified as "transferors"), the control requirement is not

satisfied. **Mailloux v. Commissioner**, 320 F.2d 60 (5 Cir. 1963).[12]

The Eighth Circuit decision is tantamount to reintroducing the concept that momentary or fleeting control is sufficient to satisfy the statutory requirements. This concept has been clearly rejected by the Second Circuit.

Petitioner divested himself of all stock in New Utilities within thirty (30) days of PUC's liquidation. The shareholders of PUC who owned stock in New Utilities, and the respective amounts thereof, at the close of 1963 are as follows:

Name	Shares
Vernon J. Giss	501
George W. Dickey	501
William M. Dickey	200
Raymond H. Thornton	200
Total	1,402

Where a transaction is characterized as a reorganization, the judicially developed doctrine of continuity of interest must be present. **Pinellas Ice & Cold Storage Co. v. Commissioner**, 287 U.S. 462 (1933); **LeTulle v. Scofield**, 308 U.S. 415 (1940); **Cortland Specialty Co. v. Commissioner**, 60 F.2d 937 (2 Cir. 1932). The continuity requirement is satisfied in a liquidation-reincorporation transaction when the shareholders of the liquidated corporation obtain the requisite degree of continuity in proprietary affairs of the new corporation. The critical element is the degree of continuity which must be established before the

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[12] The facts are reported in T.C.M. 1961-188. Taxpayer conveyed property to a controlled corporation for 900,000 shares of stock, and then immediately reconveyed stock to third parties who did not transfer property to the corporation.

transaction can be cast in the form of a Type D reorganization, *i.e.*, the presence or absence of the control requirement.

Conspicuous by its absence is the requisite degree of control. This factor sharply differentiates the position taken by the Eighth Circuit from the position taken by two other circuits.

The Second and Ninth Circuits have both concluded that control is an essential element before a Type D organization can be formulated. In **Commissioner v. Berghash,** 43 T.C. 743, 755-56 (1965), **aff'd.** 361 F.2d 257 (2 Cir. 1966), the ownership interest of the shareholders dropped from ninety-nine percent (99%) in the liquidated corporation to fifty percent (50%) in the new corporation. The Ninth Circuit has extended this theory, holding that the control requirement cannot be satisfied by an aggregation of direct and indirect ownership. In **Breech v. United States,** 439 F.2d 409 (9 Cir. 1971), the former shareholders owned twenty percent (20%) of the new corporation directly and the remaining eighty percent (80%) was owned by yet a third corporation, seventy-five percent (75%) of which was owned by the shareholders of the liquidated corporation.

Conversely, when the shareholders of the liquidated corporation own at least eighty percent (80%) of the stock in the new corporation, the transaction readily lends itself to characterization as a Type D reorganization. The Second Circuit had little difficulty in arriving at this conclusion where the three shareholders, who owned one hundred percent (100%) of the liquidated corporation, owned ninety percent (90%) of the new corporation. **Moffatt v. Commissioner,** 42 T.C. 558 (1964), **aff'd.** 363 F.2d 262 (9 Cir. 1966), **cert. denied** 386 U.S. 1016 (1967).

The Eighth Circuit has chosen to deviate from the lead established by the Second and Ninth Circuits. The position

adopted by this Circuit casts a penumbra of uncertainty over the entire liquidation area.

This conflict, and the uncertainty created thereby, justifies the grant of certiorari to review the judgment below.

CONCLUSION

The Petition for a Writ of Certiorari should be granted for the reasons set forth herein.

Respectfully submitted

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APPENDIX A

United States Court of Appeals
for the Eighth Circuit

Nos. 71-1571 and 71-1586

Stephens, Inc.,
Appellee and Cross-Appellant,

v.

United States of America,
Appellant and Cross-Appellee.

} Appeals from the United States District Court for the Eastern District of Arkansas.

Submitted: May 9, 1972.

Filed: July 10, 1972.

Before LAY, BRIGHT and ROSS, Circuit Judges.

LAY, Circuit Judge.

This is an appeal arising out of a judgment in the sum of $576,424.63 in favor of the taxpayer in a suit for refund of taxes. The focal issue turns on whether the claim of the taxpayer, Stephens, Incorporated, that it was acting as a securities dealer when handling the stocks of five separate corporations, is correct. The district court held that as to four of these corporate stocks—Hollis & Company, V. E. Schevenell, Incorporated, Tuf-Nut Company and Public Utilities Company of Crossett, Arkansas—the tax-

payer qualified as a "dealer," thus enabling it to claim certain sale or inventory losses for the years of 1960, 1964 and 1965 resulting from a devaluation of the stock in question. *Stephens, Inc. v. United States*, 321 F.Supp. 1159 (E.D. Ark. 1970). The government appeals this determination. The district court also found that as to the stock of Stephens Finance Company, taxpayer was not a "dealer." On a separate issue the court ruled against the taxpayer's contention that it had accomplished a taxable liquidation of the Public Utilities Company of Crossett, Arkansas. Stephens, Inc., cross-appeals these rulings. We reverse and remand with directions to enter judgment in favor of the government.

Stephens, Incorporated (hereinafter taxpayer) is the nineteenth largest investment house in the United States. It is a member of the Mid-west Stock Exchange and an associate member of the New York Stock Exchange. Taxpayer's policy is to initially place all securities which it purchases in its merchandise inventory. Then within 30 days those securities which are to become a part of its investment portfolio are segregated and clearly identified as held for investment only. The securities remaining in inventory at the end of its fiscal year May 31, are valued at cost or market whichever is lower. Any decline in the market value of inventoried securities is used to increase taxpayer's "cost of Goods Sold" deduction in the year when the decline occurs. This inventory method is, of course, available to "dealers" only. See Treas. Reg. 1.471-5.[1]

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[1] Treas. Reg. 1.471-5:

"For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."

The government contends that taxpayer was not entitled to inventory the stocks of the five above-named corporations and thus should not be allowed to deduct the decrease in market values of each of these shares. This decrease, the government urges, was created by the taxpayer when it gained control of each corporation and then caused a substantial dividend to be paid to itself thus depleting the surplus and deflating the market value of the stock. The tax benefit which the government seeks to prevent occurs when taxpayer claims the 85 per cent dividend received deduction.[2] This enables taxpayer to pay tax on only 15 per cent of the extraordinary dividend, while at the same time deducting an inventory adjustment in an amount approximately equal to the amount of the dividend which it has received. The government challenges the inventory loss adjustment on the basis that in each of these instances the taxpayer was not acting in its capacity as a "dealer in securities" within the meaning of the above cited Treasury regulation.[3]

The taxpayer contends that it was its purpose in handling these stocks to utilize the dividend as a means of reducing the corporate equity and thereby improving each corporation's ratio of earnings to capital. This, it claims, improved the salability of these shares and is a legitimate merchandising function in keeping with usual dealership operations.

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[2] Section 243(a) provides:

"In the case of a corporation, there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter."

[3] The government's alternative argument that the dividend received deduction should be disallowed under Section 269 need not be dealt with here in view of our disposition of the primary argument.

The question of whether or not a particular person is a dealer within the meaning of the term as defined in the Commissioner's regulations involves a mixed question of law and fact. *Schafer v. Helvering*, 299 U.S. 171 (1936); *Helvering v. Fried*, 299 U.S. 175 (1936); *Helvering v. Einhom*, 299 U.S. 175 (1936); *Edmund S. Twining*, 32 B.T.A. 600, aff'd 83 F.2d 954 (2 Cir. 1936), cert. denied, 299 U.S. 578; *Berks County Trust Co. v. Commissioner*, 78 F.2d 810 (3 Cir. 1935); *Hammitt v. Commissioner*, 79 F.2d 494 (3 Cir. 1935). As stated by the Board of Tax Appeals, this conclusion "involve[s] the proper interpretation of the Commissioner's own regulations and the application of those regulations to the facts." *Lansing McVickar*, 37 B.T.A. 758, 761 (1938).

Treasury Regulation § 1.471-5 provides the basic structure of the definition of "dealer in securities." Numerous cases dealing with this question have elaborated on and clarified this meaning. The Supreme Court has pointed out that a dealer may inventory only those securities which he purchases "to create a stock of securities to take care of future buying orders in excess of selling orders" as opposed to those "purchased for the firm's own account solely in the expectation of a rise in the market, for sale to anyone at a profit." *Schafer v. Helvering*, 299 U.S. 171, 174 (1936). See also *Frederic H. Brendle*, 31 B.T.A. 1188 (1935). Thus, the economic advantage which a dealer seeks to attain through his handling of a security is derived from the markup which he charges his "customers" above the original purchase price of the security, not from any anticipated rise in the market value of the shares. The Tax Court has explained the dealer's profit motive in this manner:

> "In determining whether a seller of securities sells to 'customers' the merchant analogy has been employed. . . . Those who sell 'to customers' are

comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. . . . Such sellers are known as 'dealers.'" *George R. Kemon*, 16 T.C. 1026, 1032-1033 (1951).

The Court of Claims has recently observed:

> "The normal goal of a dealer or merchant in securities is the making of a profit *on the price of the security itself*, or by acting in the *traditional manner* of middleman or broker, to earn a *commission* or to enjoy some other *dealer concession.*" *Brown v. United States*, 426 F.2d 355, 364 (Ct.Cl. 1970). (Emphasis ours.)

That the profit must be attained on the resale is emphasized by the controlling regulation 1.471-5 when it states that a "dealer" is "one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived *therefrom.*" (Emphasis ours.)

It is therefore with some difficulty that we view the following statement of the trial court:

> "It is true that substantial profit proved not to be made from the resales proper, but *the Court does not read the Regulation as requiring that the dealer's anticipated or hoped for profit be derived entirely from the resale itself.* Regard is to be had to the overall dealings with the respective stocks.

"The testimony of Vernon Giss, a Vice President of Stephens and its Secretary-Treasurer, was to the effect that the book values of the stocks were so high that the stocks *were not readily saleable at those values;* that when the stocks were bought by Stephens *it was contemplated that the dividends would be declared* and the values of the stocks written down. As the Court has suggested heretofore, and as Mr. Giss testified, *the dividends enabled Stephens to recover some of its costs;* also the reduction of the inventory values of the stocks made them more marketable. Indeed *without the write downs Stephens probably could not have sold the stocks and could not have made a profit on its overall transactions with them.*" 321 F.Supp. at 1165. (Emphasis ours.)

If this view were to be accepted it would mean that a merchant could properly acquire and inventory a security which he recognized at the outset could not be sold at a profit, but with the intent of securing his profit from the dividends or interest received from the security during the interim between purchase and sale. To the contrary, it is well established that "investor" status attaches to anyone, including a recognized "dealer," who acquires securities with the primary intent to profit from their income yield. See *United States v. Chinook Inv. Co.*, 136 F.2d 984 (9 Cir. 1943); *Commissioner v. Charavay*, 79 F.2d 406 (3 Cir. 1935); *Securities Allied Corp. v. Commissioner*, 95 F.2d 384 (2 Cir. 1938), cert. denied, 305 U.S. 617. This is true even though the taxpayer has the status of "dealer" with respect to other similar securities which it properly holds in its inventory. *Brown v. United States*, 426 F.2d 355 (Ct.Cl. 1970); *Schafer v. Helvering*, supra; *Harriman Nat'l Bank v. Commissioner*, 43 F.2d 950 (2 Cir. 1930); *Hammitt v. Commissioner*, 79 F.2d 494 (3 Cir. 1935); *Vaughan v. Commissioner*, 85 F.2d 497 (2 Cir. 1936), cert. denied, 299 U.S. 606; *Carl Marks & Co.*, 12

T.C. 1196 (1949); *Stern Brothers & Co.*, 16 T.C. 295 (1951).[4]

As the facts are briefly reviewed below, we find that taxpayer was not a "dealer" with respect to the stocks of Schevenell, Tuf-Nut, Stephens Finance Co. and Public Utilities.[5] As the facts will demonstrate, taxpayer was not seeking to profit from the traditional dealer markup, commission or handling charge in any of these instances. Moreover, it is apparent that Stephens handled these stocks, not as securities which formed part of a supply of inventory for sale to regular customers as they appear,

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[4] Of course, the fact that a dealer receives the income earned by a security during the "carry" period does not automatically make him into an investor. In such an instance the income yielded may be merely incidental to his primary purpose of profiting by the resale of the security to his customers. *Stokes* v. *Rothensies*, 61 F.Supp. 444, 450 (E.D. Pa. 1945), aff'd 154 F.2d 1022 (3 Cir. 1946). By contrast, where the taxpayer's motives in acquiring the stock is to gain control of and force a reorganization of a corporation for the realization of gain when the issuing company redeems its stock or pays a liquidating dividend, such stocks are not properly merchandise inventory. *George R. Kemon*, supra, 16 T.C. at 1033.

[5] We do not find it necessary to reach the issue concerning Hollis & Co. Notwithstanding the trial court's finding that taxpayer was a dealer as to this stock, we find no justiciable issue for us to resolve. The government disallowed the inventory adjustment claimed on this stock in an audit of taxpayer's fiscal 1962 tax return. The taxpayer did not file a claim for refund to challenge that determination. The statute of limitations now bars any refund from that year. Stephens has raised the issue of the propriety of this adjustment in this lawsuit, not for purposes of obtaining a refund, but on the theory that if the deduction were proper there may be a possible net operating loss carryover deduction to fiscal 1964 and 1965 which are open years before this court. However, the government points out that there has been no showing by the taxpayer that even if it were entitled to the inventory deduction, a loss would result or that such a loss, if any, would be carried *forward* to these later years. This court cannot render advisory opinions and is limited to dealing with questions which have some demonstrable effect on the refunds at issue here. Under these circumstances the question of the proper treatment of Hollis stock should not have been examined in the lower court and cannot be reviewed here.

but rather as vehicles through which it transacted the purchases and sales of operating corporations. The record makes clear that Stephens was engaging in the merchandising of businesses as profitable ventures for investors seeking to buy whole operating units though its method of doing so was through the purchase and sale of stocks. After acquiring control of a corporation, Stephens would set about managing the operation of the company, restructuring the corporate package and making whatever changes it deemed necessary to improve the salability of its "product." In many instances this was done with the knowledge that the original purchase price would not be recovered on resale but that the substantial dividend which it would cause to be paid to itself would enable it to market the corporation at a lesser price while at the same time providing it with a profit from its activities. We find this method of merchandising is not within the traditional meaning of "dealing" in securities and that such securities, therefore, are not a proper part of a dealer's inventory. The facts set out below amply demonstrate the reasons for our holding.

V. E. SCHEVENELL, INCORPORATED and TUFNUT COMPANY,

Despite their factual differences we consider these two companies together since there exist certain similarities in taxpayer's handling of these stocks.

On November 11, 1963, taxpayer purchased all of the outstanding stock of V. E. Schevenell, Incorporated for $369,915.09. Prior to making this purchase taxpayer arranged to make an immediate resale of this stock to three purchasers. The resale price was to be substantially less than the original purchase price since it was agreed that after taxpayer acquired these shares it would cause Schevenell to pay it a dividend of $190,000. It is claimed

the dividend was intended to reduce the equity of the corporation so that the purchasers would need to make less of an investment to acquire the business.[6] The dividend was paid on November 19, 1963, and thereafter, on December 13, 1963, taxpayer sold this stock in accordance with the agreement for $182,000.00. On its fiscal 1964 tax return, taxpayer reported the dividend as income and claimed a dividend received deduction of $161,500. Taxpayer also reported an ordinary loss deduction of $187,-915.09 for the loss which occurred upon the sale of these shares. It is this latter deduction which is challenged by the government.

Taxpayer acquired all of the outstanding stock of Tuf-Nut (then known as Little Rock Tent & Awning Company) on January 1, 1965, for $2,330,000.72. These stocks were immediately placed in inventory. At the time of purchase the company had made a substantial profit from the manufacture of work clothing and casual wear so that it had cash of $900,917.21 and an earned surplus of $1,619,514.96. Once again taxpayer acquired the shares of stock with the intent of declaring a substantial dividend to itself to bring down the equity of the company. Taxpayer also planned here to recapitalize the corporation and borrow money so that the company's annual earnings of $100,000 would have a more favorable relationship to its capital. This, it was thought, would make a more attractive investment for buyers.

Eight days after purchase taxpayer caused this corporation to declare a dividend of $800,000. Thereafter, the

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[6] The taxpayer contends that its purpose throughout was to resell this stock and to "accommodate" the purchasers by reducing the resale price through the declaration of a dividend and by arranging a loan to enable them to pay the balance. The taxpayer claims that these purchasers were unable to acquire the corporation outright because of their financial circumstances. Thus, it is claimed, Stephens was providing a dealer service in this transaction.

corporation was recapitalized with two classes of stock, its name was changed to Tuf-Nut Company, and then additional dividends of $900,000 cash and real estate with a book value of $85,040.21 were distributed to taxpayer. With the equity of the corporation so reduced, Stephens then began a program of merchandising this restructured company. However, it did not offer these stocks for sale to its regular customers as they might appear, but rather, taxpayer set out to find a purchaser who was already in the clothing industry. Ultimately in July of 1965 the company was sold to Key Work Clothes Company for approximately $600,000.

For its taxable year ending May 31, 1965, taxpayer filed a consolidated return with Tuf-Nut which enabled it to eliminate from the reported income 100% of the dividends that were received. On that same return taxpayer claimed an inventory adjustment of $1,647,000.72 to reflect the decline in market value of the Tuf-Nut shares which occurred by reason of the payment of these dividends.

We think it clear that taxpayer was not acting as a "dealer" within the meaning of the regulation in either of these instances.

The record demonstrates in both cases that the economic gain which taxpayer planned to derive included the receipt of the dividend income. At the time taxpayer purchased these companies it fully contemplated that it would not make its profit from a resale at a price above the original acquisition cost or from a dealer commission. Its plan was admittedly to remove the excess surplus of each company by means of the dividend, with the result that a *smaller* per share price could be charged on resale which, *when combined with the dividend,* would exceed the original outlay that it had made for these stocks. In the case of Schevenell this amounted to a profit of $2,084.91 since taxpayer received a dividend of $190,000 and a resale price

of $182,000 in return for its original investment of $369,-915.09. With Tuf-Nut, taxpayer received a total of $2,385,-040.21, when the dividends and resale price are combined, in return for its original investment of $2,330,000.72. In each instance no profit would have resulted without reaping the largely nontaxable extraordinary dividend as part of the expected gain. This is not the type of profit a "dealer" seeks. As *Brown v. United States,* supra, 426 F.2d at 364, points out, the goal of the dealer is to make a profit "on the price of the security itself" or by acting "in the traditional manner" as a middleman seeking a "commission" or "some other dealer concession." All of these aspects are lacking here.

We think it clear that the intended dealer's profit must accrue strictly from the sale of the security itself and cannot be planned to arise from the necessity of combining the investment income yielded by the security and the ultimate resale price. It may be true that a dealer will incidentally profit by the income earned by a security during the "carry" period, but in a true "dealer" situation this profit is not sought or planned for as a partial remuneration of his original outlay. Thus, we hold that taxpayer's scheme in each of these instances of recovering a profit on his original investment through the combined return of both dividends and resale price excludes him from the "dealer" classification with regard to these shares. Moreover, taxpayer's methods of merchandising these stocks were more in the nature of promoting an operating business than handling these securities, *as securities.* This factor, too, bolsters our determination that taxpayer was not acting as a "dealer" in either of these instances. As a result, we hold that the loss which occurred on the resale of Schevenell shares must be treated as a capital loss and the inventory adjustment claimed on the Tuf-Nut stock is not allowable.

STEPHENS FINANCE COMPANY

In 1952 taxpayer and a partner, T. J. Raney & Sons, formed the El Dorado Water Company by transferring certain water utility assets into the corporation in return for common and preferred stocks which each held in equal amounts. Taxpayer and Raney then jointly operated the water company until 1959 when taxpayer acquired all of the outstanding shares. From the time the business was incorporated taxpayer held its shares in inventory. The preferred stock was sold, although it was later reacquired in 1959. Taxpayer, however, sold none of the common shares. The record shows that no sales of this stock occurred because taxpayer refused to sell at the normal dealer markup and instead sought to double its investment upon resale. In 1959, after taxpayer gained complete control of this corporation, it sold all of the water utility assets to the City of El Dorado for a profit of $737,672.44. The name of the corporation was then changed to Stephens Finance Company and the company entered into the business of lending money. There is no evidence that the stock of this company was offered to customers at any time after taxpayer gained control.

On January 1, 1960 and May 31, 1960, taxpayer caused Stephens Finance Company to pay it dividends totalling $704,375.81 which it reported on its 1960 tax return as dividend income subject to a dividend received deduction of $598,719.44. On this same return taxpayer claimed an inventory adjustment of $462,500 to reflect the decreased market value of this stock after the payment of the dividend. The government challenges this latter deduction.

The district court held that taxpayer was not a "dealer" with respect to this stock since the corporation was not formed for the purpose of resale. Taxpayer appeals contending that the stock was held for resale as is evidenced by its placing these shares in its inventory rather than

in its investment portfolio. Taxpayer contends that there are only two methods by which stock can be handled by a dealer. If the stock is to be treated as held for investment purposes then it must be segregated and clearly identified as such as Section 1236 requires. All other stock, taxpayer contends, automatically becomes a part of merchandise inventory.

We agree with the trial court that the facts here clearly show that taxpayer did not handle this stock as a "dealer." The failure to designate a security as held for investment does not provide a conclusive result that it is a proper item of inventory. As the Tax Court points out in *Stern Brothers & Company*, 16 T.C. 295, 315 (1951):

> "The fact that a particular security is carried in general inventory alongside securities which are a part of the dealer business does not exclude the possibility that it was acquired and is held for investment and constitutes a capital asset."

The dictates of Section 1236 have been explained by the Court of Claims as follows:

> "Section 1236 of the Code, which plaintiffs invoke because these bonds were not 'clearly identified' on [its] records as securities held for investment, was obviously designed for the Service's benefit, to protect the revenue against the indiscriminate use of certain preferential Code provisions; the section should not be turned on its head so as to allow taxpayers to take advantage of still other preferential provisions by invoking their own failure to designate the securities for investment as conclusive that the bonds were held primarily for sale." *Brown v. United States*, supra, 426 F.2d at 356-357.

A taxpayer cannot control the ultimate determination of whether or not he holds a security for investment pur-

poses by his own designation or lack thereof under Section 1236. That section may deny preferential treatment to true investment securities which are not designated as such, but it cannot accord other preferential treatment to such shares by failure to comply with its dictates.

PUBLIC UTILITIES COMPANY OF CROSSETT, ARKANSAS

The transactions relating to the last corporation raise two separate issues: (1) Whether taxpayer was a "dealer in securities" with respect to this stock so that it was properly entitled to value the stock at the lower of cost or market in its closing inventory for fiscal 1963, and (2) whether the liquidation of this corporation and subsequent transfer of its assets to two newly incorporated entities in fiscal 1964 was a taxable liquidation under § 331(a) of the Internal Revenue Code or a tax-free reorganization under § 368(a)(1) and § 355 of the Internal Revenue Code. The resolution of the first issue necessarily affects the adjusted basis of this stock which must be taken into consideration in determining the ultimate gain or loss realized on the disposition of this stock whether by taxable liquidation or by sale following a tax free reorganization in fiscal 1964.

On March 28, 1963, taxpayer and two other corporations entered into a stock purchase agreement agreeing to pay $311 per share for the controlling interest in the Public Utilities Company of Crossett. As a result of this agreement taxpayer acquired 50% of this stock for $1,087,722.50, and immediately placed these shares in inventory. Vernon Giss, one of taxpayer's officers, testified that the company was advised by its legal counsel that unless it obtained an exemption from the Securities and Exchange Commission from the provisions of the Public

Utilities Holding Act it could be declared at any time a Public Utility Holding Company. This, he explained, would not interfere with taxpayer's business of buying and selling securities, but any further financing operations carried on by the company would have to be approved by the Commission. Thereafter, Mr. Giss testified, the Director of the Public Utility Section of the S.E.C. advised them that if they intended to only temporarily hold the stock and to dispose of it within a reasonable time, they would not be in violation of the Act. Although no specific time period for exemption was set out and no written exemption obtained, taxpayer decided to sell this stock by December of 1963 in order to escape the consequence of being found a Public Utility Holding Corporation.

On cross-examination Mr. Giss testified that the utility company was acquired with the intent and purpose of declaring a dividend in order to provide cash to pay the purchase price. On May 29, 1963, a dividend of $111 per share was declared which netted taxpayer $388,222.50. This amount was reported as dividend income on taxpayer's fiscal 1963 return subject to a dividend received deduction of $329,989.13. The usual corresponding inventory adjustment was made, giving taxpayer a deduction of $388,222.50 to reflect the decrease in market value of this stock after payment of the dividend.

The Public Utilities Company of Crossett provided the electric, telephone, natural gas and water services to the City of Crossett. After it was announced that taxpayer had been the successful bidder in acquiring this company, a number of unsuccessful bidders approached taxpayer seeking to buy this stock. Taxpayer, however, made no sale. The testimony of Vernon Giss indicates that from the outset taxpayer acquired this corporation with the purpose of reorganizing it and improving its potential profit on resale.

Before discussing in detail the procedures followed in restructuring this company, the issue of whether or not taxpayer was a dealer with respect to this stock should be resolved here. If taxpayer was a "dealer" the government concedes there is no further purpose in determining the tax consequences of the later liquidation and reincorporation.[7]

Upon audit of the 1963 return the Internal Revenue concluded that taxpayer could not claim dealer status with respect to this stock and thus was not entitled to reduce its ending 1963 inventory by the amount of decline in the market value of this stock. At the time of the audit taxpayer paid the resulting deficiency and did not file claim for refund to challenge this determination. The statute of limitations now bars any refund of 1963 income tax. However, unlike the situation dealing with the Hollis stock (n. 5 supra), the question of the propriety of the government's audit adjustment is reviewable here since this determination will affect the amount of the refund claimed in the 1964 year.

The trial court found that taxpayer was a "dealer in securities" with respect to this stock. This holding was apparently on the ground that taxpayer acquired the stock with the intent to resell it. We again disagree. Viewing the transaction as a whole, the record establishes that taxpayer acquired this corporation with the intent to break it up into separate more salable units after drawing off as much cash as possible via the dividend route. The record fails to show that the taxpayer here acquired these shares for the immediate purpose of creating "a stock of

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[7] Approval of the inventory write-down deduction would result in a lower cost basis for this stock. Thus, when using this lesser amount to determine the gain or loss on either the liquidation or the late sale of the shares of the transferee corporation a gain would result in each instance. The government concedes that it would make no difference whether this gain is taxed at the time of liquidation or at the time of the late sale.

securities to take care of future buying orders in excess of selling orders." *Schafer v. Helvering*, supra. To the contrary, taxpayer (without explanation in this record) turned away several prospective purchasers immediately after it acquired these shares. Thus, we conclude that even though taxpayer acquired this stock with the expectation that it would ultimately dispose of it before the S.E.C. took action, the underlying purpose of the acquisition was to restructure the organization so as to obtain a profit from the increased market value of the planned separate units as existing operating businesses. As explained in our discussion of Schevenell and Tuf-Nut, supra, this technique of improving the salability of a stock by acquiring control of a corporation, entering into the management and operations of its business, and reorganizing the capital structure of the entity is totally outside the traditional scope of a "dealer's" activities. *Cf. George R. Kemon*, 16 T.C. 1026, 1029, 1033 (1951). As such, we hold the ultimate resale motive which is the basis of the trial court's holding is insufficient to support the court's determination that taxpayer is a "dealer in securities."

Our determination that taxpayer was not a "dealer" in the stocks of the Public Utilities Company requires us to now meet the next issue—whether the liquidation of this company and subsequent reincorporation of its assets and liabilities into two new structures was a taxable liquidation or a tax free reorganization. The trial court held that it was a tax free reorganization rejecting the taxpayer's claim that it creates an allowable deduction in fiscal 1964.[8] If the government is correct then this loss

[8] The taxpayer had originally reported a gain from this transaction. Of course, this gain was computed by taking into account the reduction in basis which occurred by reason of the 1963 inventory write-down deduction. Our denial of this write-down deduction causes this stock to retain its original high cost basis, and since this basis exceeds the amount taxpayer received in exchange at the time of the liquidation, a loss results from this transaction.

is not recognized, and, instead, the taxpayer's original high cost basis for this stock carriers over and becomes the basis of the new stock.[9] See Section 358(a), Internal Revenue Code of 1954. Ultimately these latter shares were sold by taxpayer to its own controlling shareholders. The parties have stipulated that if any loss resulted from this sale, such loss would not be allowed by reason of Section 267 of the Internal Revenue Code.

We turn to the facts.

On November 5, 1963, taxpayer and the other two corporate stockholders, at a joint special meeting of stockholders and directors, adopted a plan of liquidation and dissolution. Under the arrangement Public Utilities Company's assets and liabilities were to be transferred to a trustee, the corporation was then to be liquidated and the trustee was then to transfer these assets subject to their liabilities to two newly formed corporations. The stock of the new corporations was to be received by the trustee in exchange and distributed pro rata among the former shareholders of Public Utilities Company. All this was to be accomplished without any interruption of service to Public Utilities Company's customers. Pursuant to this plan, an application "for approval of a plan of reorganization" was submitted to the Arkansas Public Service Commission, the details of which are set out in the district court's opinion. 321 F.Supp. at 1167. Thereafter, on November 29, 1963, Public Utilities Company was dissolved, and its assets, subject to liabilities, were transferred to a trustee. The trustee, in turn, transferred the

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[9] Another result which would ensue if this is a tax free reorganization, is that the adjusted basis of Public Utilities Company's operating assets would carry over and become the basis of those assets in the hands of the two newly formed corporations. At oral argument the parties indicated that litigation is presently pending before the Tax Court which concerns the proper basis to be used in determining the gain or loss which resulted when these assets were sold in subsequent years.

water service assets subject to their related liabilities to Crossett Water Company [hereinafter "Water"] in exchange for its stock. The balance of the assets and related liabilities were transferred to Public Utilities Corporation [hereinafter "Corporation"] in exchange for its stock.[10]

After taxpayer and the two other corporate shareholders of Public Utilities Company received a pro rata share of the stock of these two new corporations, but before December 31, 1963, each disposed of its shares so that as of that date no one who was a shareholder before the liquidation-reincorporation held stock in the two new entities. Taxpayer disposed of its shares by selling them to its two controlling shareholders, W. R. Stephens and Jack Stephens, for $603,401.95. As stated previously, whether this sale resulted in a taxable gain or a nondeductible loss is a question directly related to our determination of the proper tax treatment to be given to the liquidation-reincorporation.

Taxpayer has pointed out that it had three business reasons for effecting the above transactions: (1) It wanted a higher cost basis for the assets of Public Utilities Company for tax purposes which it intended to acquire by means of a taxable liquidation; (2) it wanted to separate the assets of the water service from the other utilities since public agitation in the City of Crossett made it appear that the city might forcibly take over the water operations by condemnation; and (3) the water service was not operating at a profit. It was felt that operating the water service as a separate corporation would point up its losses and demonstrate to the Arkansas Public Service Commission the real need for a rate increase.

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[10] On December 24, 1963, the outstanding shares of the Water Company were exchanged for shares of the Public Utilities Corporation so that the Water Company became a wholly owned subsidiary of Public Utilities Corporation and all former Water Company shareholders thereafter held Corporation stock only.

The government does not dispute the fact that taxpayer had valid business reasons for these structural changes.

It is the position of the government that these changes resulted only in a "split-up" of Public Utilities Company which is a form of tax free reorganization included within Section 368(a)(1)(D).[11] That section defines a reorganization as follows:

> "[A] transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of

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[11] The trial court found that there was a tax free reorganization "falling within the terms of at least section 368(a)(1)(F)." The government strongly urges that the transaction comes exclusively within subsection "D" and not "F" as the lower court found. Although the taxpayer contends that this was not a tax free reorganization at all, at oral argument it conceded that this could not be a "F" type reorganization because of its divisive nature.

We note that the courts are divided on the question of whether a reorganization which qualifies under "D" can also qualify under "F". See *Estate of Stauffer* v. *Commissioner*, 403 F.2d 611, 617-619 (9 Cir. 1968), and *Davant* v. *Commissioner*, 366 F.2d 874, 884 (5 Cir. 1966), cert. denied 386 U.S. 1022 (1967) finding that both "D" and "F" may apply. *Compare Gordon* v. *Commissioner*, 424 F.2d 378, 383-385 (2 Cir. 1970); *Baan* v. *Commissioner*, 450 F.2d 198 (9 Cir. 1971). And see *Columbia Gas of Maryland, Inc.* v. *United States*, 366 F.2d 991, 995-996 (Ct.Cl. 1966) holding that Congress' use of the word "mere" in "F" was meant to exclude from the scope of that section any "fractionation of a business into different corporate entities."

Although we find here that the liquidation of Public Utilities Company and subsequent reincorporation of its assets qualifies as a "D" reorganization, we do not find it necessary to reach the question of whether this necessarily prevented it from also qualifying under "F". There is no issue in this case which requires such a determination and we need not speculate as to the effect such a determination would have on the litigation presently pending in the Tax Court.

> the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."[12]

The government further points out that the transactions here qualify under Section 355 because that section governs divisive transactions wherein a single corporation splits up into two or more corporations each owned directly by the former shareholders of the single corporation. See *Commissioner v. Baan*, 382 F.2d 485, 491 (9 Cir. 1967), aff'd 391 U.S. 83 (1968). See also, Mintz, *Divisive Corporate Reorganizations Split-Ups and Split-Offs*, 6 Tax L. Rev. 365 (1951). Pointing to the "continuance of the proprietary interests in a continuing enterprise" which is one of the indicia of a reorganization that a true liquidation lacks (see *Lewis v. Commissioner*, 176 F.2d 646, 648 (1 Cir. 1949)) the government claims that taxpayer here merely reorganized Public Utilities Company by splitting it into two continuing corporate entities.

The taxpayer objects to this characterization and strongly contends that this transaction, when viewed as a whole, can only be labeled a taxable liquidation under § 331 I.R.C. It is the taxpayer's position that this entire transaction involved a series of steps each of which was interrelated and the last of which called for taxpayer and the other two corporate shareholders to divest themselves of their shares in the newly formed corporations. Thus, the taxpayer contends, when this last step is considered as part of the overall "plan," the requirement of § 368

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[12] For purposes of this section "control" is defined to mean "ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Section 368(c). The stock attribution rules of Section 318 are not applicable in determining control for purposes of corporate reorganizations. See *Hyman H. Berghash*, 43 T.C. 743, 757 (1965).

(a)(1)(D) that "immediately after the transfer the transferor, or one or more of its shareholders" be in "control" of the corporations to which the assets are transferred is absent. It is taxpayer's contention it served only as a "conduit" through which the shares of the new corporation were funneled to their new owners and therefore § 368 has no application.

The question thus becomes whether taxpayer's sale of the shares which it received in the newly incorporated corporations was a part of the plan of reorganization or whether it was a separate independent transaction. The trial court held that taxpayer failed to sustain its burden of proof with regard to this issue. 321 F.Supp. at 1167 and 1169. We sustain this finding as being supported both in law and fact.

We recognize that for income tax purposes "the component steps of a single transaction cannot be treated separately" (*Bassick v. Commissioner*, 85 F.2d 8, 10 (2 Cir. 1936), cert. denied 299 U.S. 592) and that "the question of control is to be determined by the situation existing at the time of the completion of the plan rather than at the time of the fullfillment of one of the intermediate steps." *Case v. Commissioner*, 103 F.2d 283, 286 (9 Cir. 1939). See also *Barker v. United States*, 200 F.2d 223, 231 (9 Cir. 1953); *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2 Cir. 1934); *West Texas Refining & Development Co. v. Commissioner*, 68 F.2d 77 (10 Cir. 1933); *Prairie Oil & Gas Co. v. Motter*, 66 F.2d 309, 311 (10 Cir. 1933); and *United Light & Power Co.*, 38 B.T.A. 477, 485 (1938). However, we also recognize that:

> "[It] is not essential that the stockholders should have retained their interest or control for any length of time; it is sufficient that they were momentarily in control at the required time, provided that is, that they are not under any contract or plan to give up

that control to others." Mertens, 3 *Law of Federal Income Taxation* § 20.91, Ch. 20 p. 423 (Zimet Rev. 1965).

See also *Evans Products Co.*, 29 B.T.A. 992 (1934); *Federal Grain Corp.*, 18 B.T.A. 242 (1929).

Consequently, we must examine the situation as it existed immediately after the transferor corporation [PUC] was liquidated and the shares of the two new corporations were received by taxpayer. It is well settled that if taxpayer was obligated by a pre-existing contract or plan to divest itself immediately of these shares, it did not enjoy the substantial rights of legal and equitable ownership which are necessary to a determination that it was in "control" of the transferee corporations "immediately after" receiving their shares. See, e.g., *Bassick v. Commissioner*, supra; *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3 Cir. 1937); *Herberlein Patent Corp. v. Commissioner*, 105 F.2d 965 (2 Cir. 1939), holding that a pre-existing contract requiring immediate sale of the shares of the transferee corporation prevented a tax free reorganization. See also *Rinkel v. Knox*, 196 F.Supp. 21 (D. Minn. 1961) finding the subsequent divestment a necessary part of the "plan" of reorganization. By contrast, it has been held that if the recipient was not *obligated* to make a transfer of the transferee corporation's shares, any subsequent sale of these shares even though intended from the very outset of the reorganization would have no effect on the determination that he was in control of the transferee "immediately after" he received its shares. See, e.g., *C. T. Inv. Co. v. Commissioner*, 88 F.2d 582 (8 Cir. 1937); *Wilgard Realty Co. v. Commissioner*,[13] 127

[13] The *Wilgard* decision dealt with the question of whether the necessary "control" existed to create a tax free incorporation. The similarities which exist in finding control in reorganizations and incorporations make decisions dealing with the latter question relevant here.

F.2d 514 (2 Cir. 1942), cert. denied, 317 U.S. 655; *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655 (5 Cir. 1934), cert. denied, 293 U.S. 607; *Federal Grain Corp.*, 18 B.T.A. 242 (1929). We agree with the analysis of the Ninth Circuit when it observed:

> "The statute is obviously intended to reach those cases where *unfettered substantial control* of a corporation survives a reorganization, regardless of subsequent disposition of that control." *Commissioner v. Schumacher Wall Board Corp.*, 93 F.2d 79, 81 (9 Cir. 1937). (Emphasis ours.)

The taxpayer here admits that its ownership of the shares of the transferee corporations was not "fettered" by a pre-existing contract binding it to sell these shares to its two stockholders immediately after the reorganization. However, taxpayer would have us find that its plan of reorganization necessarily included as an integral part the final sale of these shares to its shareholders. In support of this argument taxpayer points to the potential threat of the S.E.C. that it would be declared a Public Utility Holding Company if it held on to these shares too long.

In deciding the question of whether or not the ultimate sale which did occur was a part of the taxpayer's plan of reorganization, we find helpful these remarks of the Tax Court dealing with a tax free incorporation:

> "In determining whether a series of steps are to be treated as a single indivisible transaction or should retain their separate entity, the courts use a variety of tests. . . . Among the factors considered are the intent of the parties, the time-element, and the pragmatic test of the ultimate result. An important test is that of mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a

completion of the series?" *American Bantam Car. Co.*, 11 T.C. 397, 405 (1948).

According to the tests set out by that court, the later sale must be an "integral" part of the plan, a "sine qua non" without which no other step would have been taken. 11 T.C. at 406. If the sale, though contemplated from the outset of the reorganization, is merely "secondary and supplemental to the principal goal of the plan," it cannot be said to place such an *obligation* upon the taxpayer to give up his shares as would divest it of the "control" indicative of a tax free reorganization. In other words, such a step lacks the "mutual interdependence" which is required to make it an "integral" part of the plan. See also, Rabkin & Johnson, 3 *Federal Income, Gift and Estate Taxation*, § 32.08A(2)-(6).

Viewing the facts of the instant case in this light, we find ample support for the trial court's finding that the ultimate sale which taxpayer did make of the shares of the transferee corporations was not an integral part of its plan of reorganization. First, we note that the written plan which was submitted to the Arkansas Public Service Commission contained no reference to a step requiring the ultimate disposal of these shares. In addition, we observe that taxpayer did not contractually bind itself to sell these shares to its shareholders or anyone else. And further, any intent which taxpayer did foster to ultimately sell these shares drew its impetus from the external threat of a potential S.E.C. ruling and was not based upon some intrinsic need of the reorganization scheme. It is clear that taxpayer's purpose for splitting-up Public Utilities Company into two separate corporations related solely to its desire to make the water utility an independent operating entity. Whether the taxpayer or a third party held these shares thereafter was not an important consideration integrally related to the decision to so restructure these assets. Certainly, it cannot be said that the sale

which did occur was a step "without which no other step would have been taken." Viewing the transaction from either side, had taxpayer chosen (as it could have) not to sell these shares, the valid business reasons discussed above would no doubt have prompted it to carry out the same reorganization. And conversely, had taxpayer chosen not to reorganize the Public Utilities Company corporation, it would still have had to face the question of whether to sell the stock or retain it and be declared a Public Utility Holding Company. In either instance, the contemplated sale does not play an integral role *in the plan of reorganization*. Thus, we view the sales which did occur as merely "secondary and supplemental to the principal goal of the plan." 11 T.C. at 406.

We hold that taxpayer had the necessary "control" immediately after the liquidation of Public Utilities Company and the receipt of the shares of the two newly formed corporations to cause this transaction to qualify as a tax free reorganization under § 368(a)(1)(D). Thus, we affirm the lower court's finding that this was a tax free reorganization and not a taxable liquidation.[14]

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[14] We find no merit in taxpayer's further argument that because Public Utilities Company was liquidated before the incorporation of Water and Corporation, it cannot be found that Public Utilities Company had itself transferred its assets and thereby gained control of these two new corporations, and that consequently Public Utilities Company's shareholders (including taxpayer) cannot be said to have control. The fact that a liquidating trustee was used as a conduit does not change the result. Mertens states:

> "Liquidation of the transferor after transfer of the assets does not prevent the transaction from being a reorganization. The requirement of a transfer by a corporation is satisfied where such transfer is made by the liquidating directors of the transferor corporation, or some intermediary acting on behalf of the transferor." Mertens, supra, § 20.91, Ch. 20 p. 411.

See also *Reef Corporation* v. *Commissioner*, 368 F.2d 125 (5 Cir. 1966), cert. denied, 386 U.S. 1022 (1967); *Davant* v. *Commissioner*, 366 F.2d 874 (5 Cir. 1966), cert. denied, 386 U.S. 1022 (1967); *Pebble Springs Distilling Co.* v. *Commissioner*, 231 F.2d 288 (7 Cir. 1956), cert. denied, 352 U.S. 836.

Judgment reversed and remanded in No. 71-1571 with directions to enter judgment in favor of the United States of America; the cross-appeal of the taxpayer in No. 71-1586 is ordered dismissed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

APPENDIX B

United States Court of Appeals
for the Eighth Circuit

September Term, 1971

No. 71-1571.

Stephens, Inc.,
Appellee,

vs.

United States of America
Appellant.

No. 71-1586.

Stephens, Inc.,
Appellee,

vs.

United States of America
Appellant.

Appeals from the United States District Court for the Eastern District of Arkansas.

The Court having considered petition for rehearing en banc filed by counsel for appellee-appellant Stephens, Inc., and, being fully advised in the premises, it is now here ordered that the petition for rehearing en banc be, and it is hereby, denied.

Considering the petition for rehearing en banc as a petition for rehearing, it is now here ordered that the petition for rehearing also be, and it is hereby, denied.

August 22, 1972

APPENDIX C

In the United States District Court
Eastern District of Arkansas
Western Division

Stephens, Inc.,
Plaintiff,
v.
United States of America
Defendant.
LR-68-C-18.

Stephens, Inc.,
Plaintiff,
v.
United States of America
Defendant.
LR-68-C-41.

Stephens, Inc.,
Plaintiff,
v.
United States of America
Defendant.
LR-69-C-35.

Memorandum Opinion

These three cases, hereinafter referred to collectively as "the case" or "this case", involve the federal income tax liability of Stephens, Inc., of Little Rock, Arkansas, for fiscal years ending respectively on May 31, 1960, 1964, and 1965. Plaintiff, hereinafter called Stephens, filed tax re-

turns for each of those years and paid the taxes shown by the returns to be due. With respect to each year the Commissioner of Internal Revenue assessed a substantial deficiency. The deficiencies were paid; claims for refunds were denied, and in due course these suits were filed.

There are numerous issues between the parties, only some of which have been submitted to the Court for determination. Other issues have been reserved in the hope that with the submitted issues out of the way agreement can be reached as to other issues now in dispute.

The submitted issues have been tried to the Court; the materials before the Court consist of the pleadings, an agreed pre-trial order and amendments thereto, a detailed stipulation of many facts, oral testimony and documentary exhibits. At the conclusion of the trial the Court called for briefs which were submitted in due course. Later, the Court heard oral argument and still later received and has considered supplemental briefs filed by both sides. This memorandum incorporates the Court's findings of fact and conclusions of law dealing with the submitted issues.

Stephens is the 19th largest investment house in the United States, and it deals in stocks and bonds of all kind, including stocks that are not listed on stock exchanges or registered with the Securities and Exchange Commission. It is a member of the Mid-West Stock Exchange, and is an associate member of the American Stock Exchange. It does not hold a seat on the New York Stock Exchange.

All of the stock in Stephens is owned by W. R. (Witt) Stephens and his brother, Jack T. Stephens. The Messrs. Stephens have been prominent in the financial and business world in Arkansas and elsewhere for many years. Their interests are wide and varied.

In the course of its dealings Stephens frequently acquires a controlling interest in other corporations, and at times operates the businesses of those corporations for longer or shorter periods of time.

Ultimately, all securities bought by Stephens are, with possibly minor exceptions, acquired with a view to resale at a profit. Some it expects to sell within a relatively short period of time; other acquisitions it is anticipated will be held for substantial periods before resale. Securities purchased during a given tax year are frequently on hand at the end of that year and at the ends of subsequent years.

Stephens maintains an inventory of securities acquired and held for resale to customers. It also maintains a portfolio of selected securities held by it for investment purposes. All securities acquired by Stephens are placed initially in inventory. Within 30 days after acquiring a given security responsible agents of Stephens determine whether it should be removed from inventory and placed in the investment portfolio.

Profits derived from the sale of securities carried in inventory are reported as ordinary taxable income. When securities carried in the investment portfolio are disposed of, Stephens claims capital gain or loss tax treatment with respect to them.

In determining its ordinary taxable income derived from the sale of inventory securities Stephens must take into consideration its "cost of goods sold". Stocks in inventory at the close of a taxable year are valued at cost or market, whichever is lower, and the closing inventory for one year becomes the opening inventory for the next.

Such inventory treatment of securities is authorized by section 471 of the Internal Revenue Code provided that

the taxpayer qualifies as a "dealer in securities" as that term is defined in Income Tax Regulations, section 1.471-5, 26 C.F.R., section 1.471-5.

Under that Regulation, a "dealer in securities" is a merchant of securities who has a regular place of business, and who is regularly engaged in the purchase of securities and their resale to customers, that is to say, one who, as a merchant, buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. A dealer in securities may also acquire securities not for resale to customers but for the purpose of investment or speculation; but he is not considered a "dealer in securities" with respect to securities so acquired and held.

Securities acquired and held for investment or speculation are capital assets and are entitled to capital gain (or loss) treatment if the dealer so acquiring and holding them complies with section 1236 of the Code. That section provides that the dealer is not entitled to such treatment *unless* within 30 days after acquisition of the security in question he clearly identifies it as being held for investment or speculation and thereafter does not hold it primarily for sale to customers in the ordinary course of his trade or business.

Stephens is in business to make money legitimately. It is not in the business of tax avoidance, and it does not engage in tax maneuvers for their own sake. However, the management of Stephens is keenly aware that plaintiff's dealings have tax consequences. Such consequences are quite properly and legitimately taken into consideration when Stephens is contemplating buying a given security and in its dealings with the security after its purchase. And Stephens is quick and diligent to take full advantage of all available and legitimate opportunities and loopholes to be found in the federal tax laws.

The record before the Court covers generally the period from 1960 through 1965; one aspect of the case carried us as far back as 1952. During that overall period of time plaintiff acquired and disposed of five Arkansas business enterprises, namely:

1. The water works properties in the City of El Dorado. Those properties were bought in 1952 by Stephens and by T. J. Raney & Sons, a partnership; in the same year the business was incorporated as El Dorado Water Co. In 1959 Stephens acquired the Raney stock and thereafter sold the assets to the City of El Dorado. The corporate name was then changed to Stephens Finance Co. In 1963 the corporate stock was sold to Hot Springs Corporation.

2. One half of the capital stock of Public Utilities Co. of Crossett, Arkansas (PUC) was bought by Stephens in 1963; the other half was bought by Raney Investment Co., Inc. and Raney Securities Co., Inc. Later in 1963 PUC was dissolved and was supplanted by two new corporations, Public Utilities Corporation of Crossett, Inc. and Crossett Water Co., Inc. Prior to December 31, 1963, Stephens sold its interest in the Crossett operations.

3. All of the capital stock of Little Rock Tent & Awning Co., the name of which was later changed to Tuf-Nut Manufacturing Co., was bought by Stephens in early 1965; that stock was sold in July of that year.

4. All of the capital stock of Hollis & Co. was bought in 1962. By May 31, 1965, 10 percent of it had been sold.

5. All of the capital stock of V. E. Schevenell, Inc. was purchased on November 11, 1963, and was sold on December 13, 1963.

The El Dorado properties were bought from General Water Works Company of Pine Bluff, Arkansas. The

stocks in the other corporations were closely held; none was listed on any stock exchange or was traded generally, or was registered with the Securities and Exchange Commission. There was no general public demand for the stocks.

All of the corporations, including El Dorado Water Works Co. after it was formed, were solvent corporations with substantial net worths. All of them had equities that were disproportionate to current earnings. As a result, the stocks were not readily saleable at their book values which were tantamount to their "market values."

The stocks that have been mentioned were not placed in the investment portfolio; all of them were treated as inventory stocks. In each instance Stephens (or Stephens and Raneys to the extent involved) caused the corporations issuing the stocks to declare the pay large cash dividends to Stephens (or to Stephens and Raneys to the extent involved). In each instance the inventory value of the stocks was "written down" to reflect the reductions in market values caused by the dividends. In each instance the stock was sold at or near the written down value.

With respect to the dividends paid to plaintiff, the plaintiff took the dividends received credit or deduction authorized by section 243 of the Code. In four instances out of five that credit or deduction amounted to 85 percent of the dividend received. In the fifth case the credit amounted to 100 percent of the dividend.

The inventory write downs resulted in an increased costs of goods sold by plaintiff in the tax years involved here and were of substantial tax benefit to Stephens in connection with its overall operations during the years in question.

The transactions that have been outlined down to this point have given rise to controversy between the parties

with respect to all five corporations that have been mentioned. There is another and entirely separate controversy arising out of the alleged "liquidation" or "reorganization" of PUC which took place in late November and early December, 1963. The Court will dispose first of the questions common to all of the stocks and will then dispose of the PUC controversy.

I

The Government does not deny that Stephens was and is a "dealer in securities" in a general sense; but the Government does deny that Stephens was a "dealer in securities" with respect to the particular stocks here involved. The Government's theory is that while none of these stocks were ever put in plaintiff's investment portfolio or otherwise identified as investment stocks, nonetheless they were in fact acquired for investment or speculation and were not entitled to inventory treatment.

Plaintiff says that the stocks were bought for resale and not for speculation or investment. Plaintiff goes further, however, and advances a more fundamental contention which the Court will discuss at this point.

The contention is that a stock bought by a dealer in securities is either an inventory stock or an investment stock, and that regardless of his subjective intent when he acquired the stock the dealer has the option of determining how the stock is to be treated for tax purposes and if he does not exercise the option expressly by identifying the stock as investment stock, it is automatically inventory stock so that the dealer is entitled to include it in his inventory and value it at the end of the year at cost or market, whichever is lower.

The Court does not accept the contention. True, a given stock cannot at the same time be an investment

stock subject to capital gain treatment and "dealer stock" entitled to be included in inventory. But, the fact that it is not the one does not mean that it is necessarily the other. A stock that is in fact investment stock cannot properly be included in inventory. It may or may not be entitled to capital gain (or loss) treatment depending upon whether the dealer complied with section 1236. If a stock is actually acquired and held for investment or speculation, it does not lose its character of investment stock simply because the dealer fails to comply with section 1236 and thereby loses his right to capital treatment with respect to it. The Court thinks that support for this view is found in the recent decision of the Court of Claims in Brown v. United States, 426 F.2d 355.

The question, then, is whether as a matter of fact Stephens acquired the respective stocks for the purpose of resale or whether it acquired them for the purpose of holding them for investment or speculation. To that question the Court will return in due course.

II

Government contends that the tax advantages claimed by Stephens were properly disallowed under section 269 of the Code. That section provides that if a taxpayer acquires control of a corporation for the principal purpose of avoiding federal income tax liability by securing the benefit of a deduction, credit or other allowance to which such taxpayer would not otherwise be entitled, a claim of such deduction, credit or allowance may be denied.

The Government argues that plaintiff impermissibly acquired control of the several corporations for the primary purpose of claiming the dividends received credit and on the basis of the credits and write downs would have been unavailable to Stephens but for the acquisitions of corporate control.

That argument has some appeal but the Court does not accept it. Section 269 has been limited in application to situations in which a prosperous taxpayer has acquired control of a less prosperous corporation for the purpose of taking advantage of the acquired corporation's favorable tax opportunities. Zanesville Investment Co. v. C.I.R., 6 Cir., 335 F.2d.507; Cromwell Corporation v. C.I.R., 43 T.D. 313; Coastal Oil Storage Co. v. C.I.R., 25 T.C. 1304; Commodores Point Terminal Corporation v. C.I.R., 11 T.C. 411. Such a situation is not presented here since none of the acquired corporations had losses, loss potentials, or other tax advantages which would inure to the benefit of Stephens upon acquisition.

Alternatively, Government argues that in no event should plaintiff be permitted to take advantage of both the dividends received credits and the inventory write downs. That, the Government says, would be to allow Stephens "double deductions", which allowance the Government asserts to be improper and impermissible. The Government relies on United States v. Skelly Oil Co., 394 U.S. 678. The Court does not think that the case is in point and rejects the Government's argument.

A taxpayer has a perfect right to take advantage of all of the leverage that the tax laws give him, and he is not to be deprived of that right simply because his situation gives him more leverage than the Internal Revenue Service thinks that he ought to have. Nor is a taxpayer forbidden to kill two birds with one stone if he can do so under the tax laws as written.

If the payments received by Stephens were dividends, Stephens was entitled to take the statutory credit for them, and if the stocks were inventory stocks in the first place, Stephens was entitled to write them down to market value if that value was less than cost notwithstanding the fact that the decrease in value was largely

due to the impact of the dividends on the corporate balance sheets.

As to the character of the payments received by Stephens from the corporations, this Court has always had some difficulty with treating those payments as "dividends". It seems to the Court that from a practical standpoint the payments were nothing more than recoupments by Stephens of part of the cost of the stocks and could, and perhaps should, have been so treated for tax purposes. Under that theory no part of the payments would have been subject to taxation as dividends, nor would there have been any occasion to write down the inventory values of the stocks, assuming that they were properly included in inventory. They would simply have gone on the books at their net cost to Stephens.

However, both sides have been willing to treat the payments as true dividends, and the Government does not question the taking of the dividends credits standing alone. If that approach is satisfactory to the parties, as it apparently is, the Court will not quarrel with it.

Some may think it "unfair" to permit a corporate taxpayer which is in a position to do so to gain the tax advantage which Stephens was able to obtain in the manner that has been described. But, concepts of equity and fair play are not invariably incorporated in the tax laws. See the dissenting opinion of Justice Douglas in United States v. Skelly Oil Co., supra. And some transactions involve tax benefits to the Government which may be considered "unfair" or "unjust". Indeed, under the Court's suggested characterization of the dividends payments, it would be arguable that it was "unfair" to tax Stephens on even 15 percent of those payments.

If there are undesirable provisions in the tax laws, it is the function of the Congress, not the Courts, to change them.

III

The question now recurs as to whether Stephens bought the stocks for resale so that it would be entitled to carry them in inventory. On that issue the burden of proof is upon the plaintiff as to each of the stocks in question.

The Court finds from a preponderance of the evidence that with respect to the stocks of PUC, Little Rock Tent & Awning, Hollis & Co., and Schevenell Stephens was a "dealer in securities" within the meaning of Internal Revenue Regulations, section 1.471-5 and was entitled to accord inventory treatment to those stocks. With regard to the stock of El Dorado Water Co. the Court finds that plaintiff has failed to discharge its burden.

The stipulated facts and the testimony reflect, and the Court finds, that plaintiff bought the PUC, Little Rock Tent & Awning Co., Hollis & Co., and Schevenell stock for the purpose of reselling them and not for the purpose of holding them for investment or speculative purposes. As a matter of fact those stocks were not of a type which normally would be bought as investments by a dealer in securities or by anyone else; more properly speaking perhaps, the corporations in question were not of such nature as would make their stocks attractive for investment or speculative purposes.

The Court also finds that plaintiff intended to make a profit out of its dealings with all of those securities. It is true that substantial profit proved not to be made from the resales proper, but the Court does not read the Regulation as requiring that the dealer's anticipated or hoped for profit be derived entirely from the resale itself. Regard is to be had to the overall dealings with the respective stocks.

The testimony of Vernon Giss, a Vice President of Stephens and its Secretary-Treasurer, was to the effect

that the book values of the stocks were so high that the stocks were not readily saleable at those values; that when the stocks were bought by Stephens it was contemplated that the dividends would be declared and the values of the stocks written down. As the Court has suggested heretofore, and as Mr. Giss testified, the dividends enabled Stephens to recover some of its costs; also the reduction of the inventory values of the stocks made them more marketable. Indeed without the write downs Stephens probably could not have sold the stocks and could not have made a profit on its overall transactions with them.

The Government points to the fact that in connection with some of the corporations plaintiff provided managerial services and arranged for financing. Admittedly, an ordinary merchant has no occasion to do those things for his suppliers. Such a course of conduct, however, in some instances may be pursued by a dealer in securities. Where one corporation dealing in securities buys all of the stock of another corporation or a controlling interest in it, and where the stock cannot be sold immediately, the buying corporation may be required to exercise control of the affairs of the acquired corporation if that concern is to function, and for the same reason the former corporation may be required to arrange financing for the latter. Moreover, improvement in corporate management has an obvious tendency to improve the marketability of the stock and to increase its market value.

As stated, the Court does not find from a preponderance of the evidence that Stephens was a "dealer in securities" with respect to the stock of El Dorado Water Co.

To start with, Stephens did not "buy" the stock of the water company from any third person or persons in the sense that it bought the stock in the other corporations. The parties have stipulated that in 1952 plaintiff and T.

J. Raney & Sons, a partnership, bought the water works property from General Water Works Co. of Pine Bluff, Arkansas. The water works was later incorporated and one half of the stock was issued to Stephens and the other half was issued to T. J. Raney & Sons. There were two classes of stock. The preferred stock was sold between 1952 and 1959 to customers of Stephens, but during that period there were no sales of common stock.

When the assets were acquired originally the water works was a going concern and had good management and earnings. The Court thinks that the assets were acquired to be operated for an indefinite period of time, and that the corporation was not formed for the purpose of selling its stock other than the preferred stock that is not in controversy here. Indeed, by 1952 probably the only prospective purchaser was the City of El Dorado itself, and it seems that its legal authority to buy or condemn corporate stock was in question although there was no doubt that the city had the power under Arkansas law to buy or condemn the physical plant.

By July 1959 Stephens had arranged to sell the properties to the City of El Dorado and in connection with that arrangement it bought the stock in the water company owned by the Raneys. After the sale of the assets to the city, El Dorado Water Company's assets consisted entirely of cash, accounts receivable, and notes receivable. Early in 1960 the name of the company was changed to Stephens Finance Co. Immediately thereafter Stephens received a large dividend from the Finance Co. and wrote down the value of the stock correspondingly. From 1960 to May 8, 1963, Stephens Finance Co. was engaged in the business of making substantial loans. On the date last mentioned Stephens sold its stock in the Finance Company to a concern known as Hot Springs Corporation at book value.

Although Stephens certainly made a profit on the sale of the water assets to the City of El Dorado, and although it may have made a profit on the ultimate sale of the stock to Hot Springs Corporation, the Court is not convinced that it acquired or held that stock for resale in any conventional sense or that it was a "dealer in securities" with respect to that stock.

IV

There remains for consideration the controversy about the liquidation/reorganization of PUC in the late fall of 1963. And it is this controversy that has given the Court its greatest difficulty.

Prior to the transactions in question PUC had supplied to the citizens of the City of Crossett all four public utility services. By early 1963 Stephens had acquired one-half of the stock in PUC, and the other half had been acquired by Raney Investment Co., Inc. and Raney Securities Co., Inc. The stock was placed in the respective inventories of the purchasers at cost; there was the usual dividend (in fact two) declared in favor of the purchasers; and there was the usual write down of the inventory value of the stocks.

On the 19th of July, 1963, Stephens filed with the SEC a claim for exemption from the provisions of the Public Utility Holding Company Act of 1935 with which Stephens did not wish to comply. It was the understanding of Stephens personnel that if the company was not to come under the Act with respect to PUC it would have to dispose of its stock in that company within a comparatively short time, probably within a year after the acquisition.

The Stephens-Raney acquisition of the shares in PUC was strongly opposed by a substantial number of Crossett residents who believed that the public utilities in the city should be publicly owned, and there was talk of condem-

nation. While it was doubtful that the city could condemn the electric, gas, and telephone utilities, there was no question that it could condemn the water utility.

That situation in itself indicated the desirability of severing the water utility from the other three. In addition, the water utility had not been making money; it needed a rate increase, and there was a better chance of its getting one if it was placed on its own feet as a separate utility company.

On November 5, 1963, a joint special meeting of all of the stockholders and directors of PUC was held in the City of Little Rock. By a resolution unanimously approved the stockholders and directors adopted a "Plan of Complete Liquidation and Dissolution of Public Utilities Company of Crossett".

The plan contemplated that as of November 29, 1963, PUC would be completely liquidated and dissolved and that all of its assets would be turned over to a liquidating trustee. PUC's attorney, Mr. R. H. Thornton, Jr., who was also one of its stockholders, was directed to file as soon as possible with the Arkansas Public Service Commission an application for leave to dissolve the company, which application was to represent that the stockholders of PUC would cause public utility service to be provided to the service areas without interruption. The plan then recited:

> ". . . Although the complete liquidation and dissolution of this Corporation shall be a taxable transaction, taxable to the stockholders as provided by Section 331 of the Internal Revenue Code, it is the intention of the stockholders, subject to the approval of the appropriate regulatory agencies, that they will cause two new corporations to be organized under the laws of the State of Arkansas to which the net assets

received by them upon liquidation of the corporation shall be transferred. Upon receipt of the assets and the assumption of the liabilities these two corporations shall operate and provide the utility service to the service areas previously served by Public Utilities Company of Crossett."

On November 14, 1963, Public Utilities Corporation of Crossett, Inc. (Utilities), and Crossett Water Co., Inc. (Water), were formed as Arkansas corporations. The incorporators were Vernon Giss and R. H. Thornton, Jr., who have been mentioned, and Rose Jolley, evidently an employee of Stephens.

On the following day PUC, Utilities, and Water filed a joint application with the Public Service Commission asking for administrative approval of a proposed plan of *reorganization* along the following lines:

(a) PUC was to be *liquidated*.

(b) Corporation would buy from PUC stockholders all of the assets and assume all of the liabilities distributed to the stockholders as a result of the liquidation, except the assets and liabilities to be acquired and assumed by Water. Specifically, Utilities agreed to assume current liabilities and long term debts aggregating $1,115,377.57, "plus the sum of $1,199,872.92 payable in common stock issued by the Utilities Corporation."

(c) Water would buy and assume the rest of the assets and liabilities. The liabilities to be assumed amounted to $282,873.50, "plus the sum of $336,431.93 payable in common stock issued by the Water Company."

(d) Water agreed to supply water service to Crossett residents, and Utilities undertook to supply the other utility services.

The application then went on to say that the "proposed reorganization" should have a favorable effect on the two new companies, should be beneficial to utility customers, was in the public interest, and reflected the reasonable value of the property, plant, equipment, and other assets of the parties.

The application was granted by the Commission after a hearing on November 26, 1963, and on the same day the stockholders of PUC entered into a trust agreement containing substantially the following provisions:

1. All assets and liabilities of PUC were to be turned over to the trustee and held by him in trust for the stockholders.

2. The trustee was to convey appropriate assets and liabilities to Water in exchange for 3,000 shares of stock in Water. The other assets and liabilities were to be transferred to Utilities in exchange for 11,000 shares of the stock of Utilities.

3. While certificates covering the 14,000 shares of stock that have been mentioned were to be delivered initially to the trustee, they were to be issued in the names of the stockholders of PUC, including Stephens. Each of those stockholders was to receive a specified number of shares in Utilities and a specified number of shares in Water.

The Court will observe at this point that the total number of shares to be issued by Utilities and Water collectively was only 10 shares less than twice the number of outstanding shares in PUC immediately prior to its intended dissolution, and the total number of shares in both new corporation that each PUC shareholder was to receive was approximately, in some cases exactly, twice the number of shares that it or he owned in PUC.

It is also to be observed that none of the documents that have been abstracted by the Court indicated that any PUC

stockholder would be required, or that any intended, to divest itself or himself of shares in either Utilities or Water after those shares were delivered by the trustee.

On November 29 a certificate of dissolution of PUC was filed with the Arkansas Secretary of State. On December 2, the assets and liabilities of PUC were transferred to Utilities and Water pursuant to the plan, and presumably Utilities and Water delivered their stock certificates to the trustee who in turn delivered them to the former PUC stockholders.

On December 24, 1963, the stockholders in Water surrendered their stock to Utilities in exchange for Utilities stock on a one for one basis. Thus Water became a wholly owned subsidiary of Utilities.

Prior to December 31, 1963, all of Utilities' shares were sold by the former PUC stockholders to 24 identified individuals, most of whom are prominently connected with the Stephens and Raney interests. The shares in Utilities that were owned by Stephens were sold to W. R. and Jack Stephens.

The record, supplemented by the briefs, sets out in some detail what happened with respect to Utilities and Water after the close of 1963. The Court has considered those happenings for whatever they may be worth but does not deem it necessary to relate them here; there is no dispute about them.

Section 311(a)(1) of the Code provides that amounts distributed to shareholders in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Both sides agree that where there is a complete liquidation under section 331, a liquidation dividend received by a stockholder is treated as involving a capital gain or capital loss as the case may be.

Plaintiff says that the November-December, 1963, transactions that have been described amounted to a section 331 liquidation. The Government says that those transactions amounted to nothing more than a tax free reorganization falling within one or more of the definitions of "reorganization" appearing in section 368(a)(1) of the Code, particularly section 368(a)(1)(D) read in connection with section 355, section 368(a)(1)(E) or (F).

There is nothing new about controversies between taxpayers and the Government as to whether corporate demises have amounted to section 331 liquidations or whether they have been simply reorganizations. There are many cases on the subject.

Such a controversy arises typically when a stockholder-taxpayer receives a large sum of money in connection with the termination of the life of an original corporation but immediately appears as a stockholder in some other corporation which has acquired the operating assets of the former corporation. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (2d Ed.) section 9.05, pp. 349-350. In such a case the taxpayer contends that the first corporation was "liquidated" under section 331, and the Government contends that there was but a reorganization.

This is not a typical case because here Stephens obtained its cash payment form PUC substantially before the November-December events and treated that payment as an ordinary corporate dividend subject to normal income taxation. Indeed, considering Stephens as a corporate entity standing alone and apart from W. R. and Jack Stephens or some other Stephens controlled corporation or corporations, it is hard for the Court to see what this particular controversy is really about.

However, the controversy is here: the parties want it decided, and the Court will endeavor to do so. It seems

clear that PUC was either "liquidated" or "reorganized." The burden is on the plaintiff to establish the liquidation which it postulates.

> "The Code provides no definition of 'complete liquidation.' We reject the simplistic argument of the taxpayer that the phrase refers only to the measures required by state law to terminate a corporation's legal existence. No reason is offered as to why the observance of such mechanical procedures would prompt Congress to treat as stock redemptions payments that are in reality dividends. A more convincing indication of what distribtuions are meant to be accorded favored treatment is found in an early report of the Senate Finance Committee. S.Rep. No. 398, 68th Cong., 1st Sess., 12 (1924). There a distribution in complete liquidation was analogized to a sale of stock in that the shareholder 'surrenders his interest in the corporation and receives money in place thereof.' The corporation must have ceased to be a going corporate form, the shareholder must have disassociated himself from it. See Regs. 1-332-2(c) (1955). If the liquidated business is not resumed by the new corporation as a continuation of a going concern, there is a 'complete liquidation.' . . ."

There is no question that PUC ceased to exist as a corporation on November 29, 1963, and that its assets and liabilities passed into the hands of the trustee. Nor is there any question that on December 2 those assets and liabilities were passed on to the new corporations which issued their stock in payment therefor, which stock was turned over to the former PUC stockholders. It is also unquestioned that Stephens and the Raney corporations sold their stock to individuals prior to December 31, 1963. While the record is not entirely clear, it is inferable that those sales were not made until after Water had become

a subsidiary of Utilities. If so, the sales to the individuals took place between December 24 and December 31.

If PUC's overall plan had stipulated that the certificates of stock in Utilities and Water would be issued in the name of the Trustee, and that he would sell the stock to outsiders and turn the money over to the former PUC stockholders, the Court would have no difficulty in finding a section 331 liquidation.

As has been, however, the plan did not so provide, and the transactions were not handled in that way. Immediately after the events of December 2, 1963, the same corporations and people which and who had owned PUC four days before were the owners of Utilities and Water, and the proportions of ownership were substantially the same. And Utilities and Water were carrying on the same business that had been carried on by PUC. And that situation continued to exist until probably the last week in December.

In the last analysis, the Court is concerned here with what the stockholders of PUC did, not what they might have done, or what they say that they did, or what they intended to do.

Granting that the supplanting of PUC with Utilities and Water was not a "tax dodge", and that there was valid business reasons for every step taken by the PUC stockholders, it seems to the Court that the business objectives involved could have been achieved as well by means of and after a reorganization as by means of and after a liquidation. And regardless of what was intended to be done with PUC and of what its directors and stockholders may have tried to do with it, the Court is not persuaded by a preponderance of the evidence that they actually did anything more than reorganize it into two corporations, admittedly a change in business form and identity, but with no substantial change of ownership or operation.

It is true that the situation that was created did not last very long, but it was what it was as long as it lasted, and the Court is not convinced that the fact that its duration was short was more than a coincidence or that it is of controlling importance.

An order will be entered adjudicating the submitted issues in accordance with the foregoing.

Dated this 15th day of October, 1970.

/s/ J. Smith Henley
United States District Judge

APPENDIX D

In the United States District Court
Eastern District of Arkansas
Western Division

Stephens, Inc.,
Plaintiff,
v.
United States of America,
Defendant.
LR-68-C-18.

Stephens, Inc.,
Plaintiff,
v.
United States of America,
Defendant.
LR-68-C-41.

Stephens, Inc.,
Plaintiff,
v.
United States of America,
Defendant.
LR-69-C-35.

Order

Pursuant to Memorandum Opinion this day filed in these consolidated cases, the Court now adjudicates the particular issues submitted to it as follows:

1. Plaintiff, Stephens, Inc., was a "dealer in securities" with respect to the corporate stock of Public Utilities Com-

pany of Crossett, Arkansas, Little Rock Tent & Awning Co., Hollis & Co. and V. E. Schevenell Co., Inc., as the term "dealer in securities" is defined in section 471 of the Internal Revenue Code and in Income Tax Regulations, section 1.471-5. Plaintiff was entitled to place the stocks of those corporations in its inventory of securities and to value them at years' end at cost or market, whichever was lower.

2. Plaintiff was not a "dealer in securities" with respect to the stock of El Dorado Water Co., was not entitled to include that stock in its inventory, and was not entitled to value it at years' end at cost or market, whichever was lower.

3. With respect to dividends paid plaintiff by all of the companies heretofore mentioned, including El Dorado Water Co., plaintiff was entitled to take the dividends received credit provided by section 243 of the Internal Revenue Code. Plaintiff was not precluded from taking that credit or those credits by reason of the inventory write downs which followed the declaration and payment of the dividends.

4. Section 269 of the Code is not applicable to these cases of the tax advantage claimed by plaintiff are not disallowable by reference to that section of the Code.

5. The transactions of November-December, 1963, which resulted in the dissolution of Public Utilities Company of Crossett, and the formation of Public Utilities Corporation of Crossett, Inc., and Crossett Water Company, Inc., did not amount to a complete "liquidation" of the original corporation within the meaning of section 331(a)(1) of the Code and amounted to nothing more than a tax free reorganization falling within the terms of at least section 3368(a)(1)(F) of the Code.

The Court retains jurisdiction of these issues for the purpose of determining other issues between the parties should such issues be submitted to the Court for determination.

Dated: This 15th day of October, 1970.

/s/ J. Smith Henley
United States District Judge